Administrative Costs in Health Insurance
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Many observers have noted that insurance companies' administrative costs are included in premiums, on top of the cost of medical benefits paid on behalf of enrollees. Insurers and analysts usually call this a "loading" percentage; it is a kind of overhead. Sometimes they talk about a similar measure—the ratio of medical benefit payouts to total premium, called the "loss ratio." (See "How Private Insurance Works*").

Different-sized buyers of insurance face different levels of such overhead. One potential reform strategy might be to seek to reduce insurance overhead and so reduce premiums for some groups. The goal would be to narrow the difference between the cost of medical benefits and the price that people face for insuring them.

It is well documented that in the private sector, the lowest loading percentages apply for large employment-based groups, especially self-insured groups. Smaller groups face higher loadings, and individuals buying on their own face the highest loadings of all.

The following three articles that document these observations are available on the SPG website. The key points of these articles are summarized with quotations here:

1. Chu & Trapnell, "Study of the Administrative Costs and Actuarial Values of Small Health Plans" (2003). This detailed actuarial analysis of insurance in two states explains that "Administrative expenses for insurers of small health plans make up 25 to 27 percent of premiums and 33 to 37 percent of claims. This compares with about 5 to 11 percent of claims for large companies' self-insured plans. For small business insurers, administrative costs break out as follows: The cost of commissions makes up 4 to 11 percent of premiums, taxes and fees make up 2 to 3 percent, general expenses make up 10 to 11 percent, and profits make up 4 to 5 percent."

2. Pauly & Nichols, "The Nongroup Health Insurance Market: Short On Facts, Long On Opinions And Policy Disputes" (2002) This literature-review article summarizes the general agreement of analysts that "[a]dministrative loads are higher in nongroup markets. Nongroup health insurance is similar to other consumer insurance (homeowners, auto, life) in terms of its administrative cost. In such insurance, selling and administrative expenses and return on risk capital typically consume 30-40 percent of the premium. The nongroup administrative "loading" percentage appears, from National Association of Insurance Commissioners (NAIC) data, to have fallen by about 10 percent in the 1990s, while the differential between group loadings and those in nongroup insurance narrowed slightly. The largest share of nongroup cost goes toward selling expenses; compared with group insurance, sales agents and brokers must spent more time per customer, so commissions and salaries must be higher. In addition, underwriting expenses are higher than in group-health settings, in which there is less need to worry about risk variation."

3.Thorpe, "Inside the Black Box of Administrative Costs" (1992). This article explains what functions are served by administrative spending. It concludes that simple comparisons of differing percentage loadings for administrative costs across types of health plan or across countries are misleading, because different plans and systems perform different administrative functions. Plans especially vary in the degree of investment they make to control costs and increase quality. The article also addresses higher small group costs: "Small-group insurance accounts for a large portion of [US, compared with Canadian] administrative expenses. There are several reasons for this. First, the economics of this market increases transaction and selling expenses. The sheer number of small firms (nearly 87 percent of all firms) increases marketing, selling, and search costs. Also, the failure rate of small firms is high-perhaps 35 percent per year. Some industry experts have noted that the average life span of small firms with insurance is less than twenty-eight months. Small firms also have substantial employee turnover; this increases administrative (and unmeasured) costs to the employer, who must submit individual employment changes each month or quarter to the insurer." The SPG Library includes an abstract; full-text access requires a subscription to *Health Affairs*.

* Another useful background summary on insurance practice is a Congressional Research Service report entitled, "Health Insurance: A Primer" (2004), also available on the SPG website.